In the Supreme Court of the United States.

OCTOBER TERM, 1876.

HENRY A. GRANT, COLLECTOR, PLAINTIFF IN ERROR,
vs.
THE HARTFORD AND NEW HAVEN RAILROAD COMPANY.
No. 86.

IN ERROR TO THE CIRCUIT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

Brief for the Plaintiff in Error.

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BRIEF FOR THE PLAINTIFF IN ERROR.

STATEMENT OF THE CASE.

This suit was instituted by the Hartford and New Haven Railroad Company against Henry A. Grant, collector of internal revenue, to recover money paid him under threat of distraint upon a special assessment made January 13, 1868, purporting to be upon undivided profits of the corporation used in construction (as below stated) in the two years ending August 31, 1867. The tax was upon the expenditures of the railroad company within those years in the erection of a stone bridge across the Farmington River at Windsor, Conn. When the road was built, it was carried across the river at this point

upon a covered wooden bridge, resting upon stone piers and abutments. In a few years this bridge was set on fire by sparks from a locomotive and burned, and a new bridge (also of wood) was placed upon the same foundation. In 1854 an unusual freshet greatly endangered the bridge then in use, and it was with difficulty that it was prevented from being swept away. A highway bridge, a few hundred feet lower down the stream, was carried away, and the town of Windsor sued the railroad company to recover damages for the loss of their bridge, alleging that the embankments and abutments of the railroad-bridge had so narrowed the stream as to send the current with greater volume and velocity against the town's bridge, and had thus caused its destruction. After several trials, in each of which the jury disagreed, this suit was settled by compromise. In 1864 it became apparent to the company, "with good reason therefor," (not stated in the record,) that the bridge in question must soon be rebuilt or replaced by some other structure; accordingly, it was temporarily strengthened, and (after full consideration of all the advantages of the change) it was determined to commence and proceed gradually with the construction of a bridge composed of continuous stone arches. This was commenced early in 1866. The fiscal year of the company, prior to 1871, terminated with the last day of August in each year. The expenditures upon this bridge up to August 31, 1866, amounted to $31,269.65, which sum was charged to the current expenses of the repairs of roads and bridges, as were the sums subsequently expended upon this bridge. During the year ending August 31, 1867, these expenditures were $24,442.95, and for the year ending August 31, 1868, they were

$23,204.95. The bridge consists of a series of seven stone arches, each of 54 feet clear span, thus giving a waterway of 378 feet, instead of but 290 feet, which was the width afforded by the former bridge.

It had been the practice of the company, for many years, to include in one account all expenditures for repairs of the road, track, and bridges, and at the close of each year to charge to this repair account all such expenditures for repairs or renewals of road, tracks, and bridges as seemed proper for keeping the road and structures in a condition to be safe for the public and economical for the company. The total expenditures charged in this account for the year ending August 31, 1867, were $255,780.32, while for the preceding year, ending August 31, 1866, they were $297,885.93, and for the year ending August 31, 1868, $326,427.99. The total income of the road for the year ending August 31, 1867, was $1,685,334.59. The total expenditures, for repairs, renewals, and all other current and incidental charges for operating the road, (except taxes,) were, during the year ending August 31, 1867, $982,518.90, equal to 59 per cent. of the gross earnings, and not more than a proper percentage of gross receipts to cover all proper, ordinary, current expenses and depreciation of the entire property; nor was the percentage of expenses to gross receipts in 1866 more than a proper one to cover such expenses and such depreciation. The company paid the 5 per cent. United States tax on dividends to stockholders during 1866 and 1867; and, *after closing the accounts of each year, and ascertaining its profits*, a like tax upon the balance of profits as it appeared in their system of accounting, *i. e.*, upon the balance over expenses and dividends, which was carried to the contingent fund.

The expenditures on the new bridge in 1866, were $2,000 a month. The value of the materials of the old bridge was $1,500, for which sum they were sold by the company. *The cost of putting up a new bridge just like the old one, at the time the stone bridge was built, would have been* $15,000; but the company were assessed upon the entire expense, without credit for the value of a bridge equivalent to the old one. The July, 1866, dividend was duly returned, and was assessed upon the company and collected August 7, 1866. The only re-assessment of which the company had notice, was the one in controversy, made upon the customary blank, and stated as being upon "earnings used in constructing new Windsor bridge, $55,712.60 × 5 per cent. = $2,785.65." This tax, with $139.28 additional, penalty for non-payment, was paid under protest and to avoid distraint. The assessment was at the statute rate and was lawful in form. The defendant (plaintiff in error) was then the collector of internal revenue for the first district of Connecticut. The company took an appeal from the collector to the Commissioner of Internal Revenue, who disallowed the appeal. Upon an agreed statement of the facts the cause was submitted to the presiding judge, who held that the tax was not due; was not (within the meaning of the law) based upon profits used in construction; and ordered judgment to be entered for the company for the full amount claimed. [Record, 6–9.]

ASSIGNMENT OF ERRORS.

The plaintiffs in error assign for error: (1.) The ruling of the judge that the $55,712.60 expended upon the bridge were not "profits used for construction." (Record, 9.) (2.) The order to enter judgment for the original plaintiffs for the whole tax exacted. (Record, 11.)

STATUTES.

The internal-revenue act of June 30, 1864, (c. 173, § 122,) provides, among other things, that all profits of a railroad company "used for construction" shall be subject to and pay a duty of 5 per centum. (13 Stats., 284.)

Under the act of July 13, 1866, c. 184, § 9, (14 Stats., 104:) "In case it shall be ascertained that the annual list, or any other list, which may have been, or which shall hereafter be, delivered to any collector, is imperfect or incomplete, in consequence of the omission of the names of any persons or parties liable to tax, or in consequence of any omission, or understatement, or undervaluation, or false or fraudulent statement contained in any return or returns made by any person or parties liable to tax, the said assessor may, from time to time, or at any time within fifteen months from the time of the passage of this act, or from the time of the delivery of the list to the collector as aforesaid, enter, on any monthly or special list, the names of such persons or parties so omitted, together with the amount of tax for which they may have been or shall become liable, and also the names of the persons or parties in respect to whose returns, as aforesaid, there has been or shall be any omission, undervaluation, *understatement*, or false or fraudulent statement, together with the amounts for which such persons or parties may be liable over and above the amount for which they may have been or shall be assessed upon any returns made as aforesaid, and shall certify and return said list to the assessor, as required by law. And all provisions of law for the ascertainment of liability to any tax, or the assessment or collection thereof, shall be held to apply, as far as may be necessary, to the proceedings herein authorized and directed." (14 Stats., 104.)

BRIEF.

The "profit" of any business is the surplus that remains after deducting from its gross receipts the necessary expenses of carrying it on, whether that surplus be retained in money, or invested in addition to or improvement of the stock, or in other property. It does not authorize the deduction of any expense which *might* properly have been incurred, but was not incurred. If a ship-owner choose to run his vessel without insuring her or her freightage, his income from her is the excess of her earnings above expenses, without deducting premiums that were not paid. That the corporation which brought this suit *might* properly have expended the $55,712.60, for which they are assessed, in repairs along the entire line of their road, but did not do so, is no reason for exemption from this tax.

The statute says nothing about hypothetical "percentages." It requires the return to be made of actual earnings and of actual disbursements; and the balance is the assessable "profits." There is just as much reason for saying that its accumulations were to rest in part upon conjecture as to say that its expenditures were.

Referring to this section, 122, this court has said, "that the policy of Congress in that act was to tax *all* gains and profits, whether divided or undivided." (Collector *v.* Hubbard, 12 Wallace, 17.) "The money in the hands of the directors may be income to the corporation, although it is not so to the stockholder till a dividend is made; and where the company invest it in buildings and machinery, or in railroad tracks, depots, rolling-stock, *or any other permanent improvements*, for enlarging *or carrying on* their legitimate business, it never becomes income to the shareholder. The invest-

ment becomes *an accretion to the capital;* and it is equally so whether they increase the number of shares or the par value of shares, or leave the shares unaltered." (Minot *v.* Paine, 99 Mass., 111.) "The corporation is the legal owner of the property, and has power, within the limits of its charter, to give to the shareholders either an increase of income or an increase of capital out of the money in its hands, according to the discretion of its directors." (*Id.*, 112.)

By the erection of this stone bridge every share was made so much the more valuable to hold, to sell, or to devise.

This stone bridge was an entirely new structure. It was not the repair of an old one, in any sense. It might have been built by funds raised by loan, or by assessment upon the stockholders, and then its cost would not have been assessable, but the $55,712.60 of profits would have been so, whether divided or undivided. The corporation had no occasion to resort to loans or to assessments, but were, fortunately, able to make this "permanent improvement for carrying on its business" from the excess of its earnings above operating-expenses. It was erected from the profits of the company; and the profits so expended were "used in construction," and not in repairs. That they *might* have been used in repairs is no reason for ignoring the actual use to which they were put, nor for changing the legal effect of so using them.

Being a new structure, built out of the profits, its entire cost was properly assessed.

EDWIN B. SMITH,
Assistant Attorney-General.

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Brief of R. D. Hubbard and H. C. Robinson,

Counsel for the Defendant.

In the Supreme Court of the United States.

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IN ERROR IN THE CIRCUIT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

Brief for Defendant.

STATEMENT OF THE CASE.

The suit was instituted by the Hartford and New Haven Railroad Company against Grant, United States Collector, to recover money paid under threat of distraint upon a special assessment made by the assessor for the First district of Connecticut, in January, 1868.

The special assessment was made under the claim made by the assessor, that expenditures made by the company in the two years ending the 3d of August, 1867, in the construction of a stone bridge across the Farmington river at Windsor, and charged by the company as repairs, were to be treated as "profits used in construction," and liable to assessment under the law.

The bridge constructed over the Farmington river at the point in question, at the time of the building of the road, was a covered wooden bridge, on stone piers and abutments. This bridge was burned by sparks from a locomotive, a few years later. The next bridge was of wood, on the same foundation. In 1854 an unusual freshet in the Farmington river greatly endangered the bridge then in use, the water rising against the flow and upper side of the bridge, and only by the active exertions of the officers of the company, and a large force of men, it was saved from destruction. A highway bridge belonging to the town of Windsor, crossing the same river a few hundred feet below, was carried off, and a suit commenced by the town against the railroad company to recover damages for the destruction of the town bridge, on the ground that the railroad company had so narrowed the water way of the river by its embankments and abutments, as to send the current with increased velocity and volume against the town bridge, and thus cause its destruction. The suit was tried there several times in a series of years, resulting in a failure each time of the jury to find a verdict, and was then settled by compromise.

In 1864 it became apparent with good reason therefor to said company, that the bridge in question must soon be rebuilt or replaced by some other structure. It was temporarily strengthened by attaching wooden arches to each of its chords, and the subject of constructing some other structure to take its place was carefully considered by the officers of the company, and in view of the danger of destruction of a wooden structure by fire, of the necessity of additional water way, demonstrated by the experience of previous years, of the great loss to the company and inconvenience to the public which would result from the destruction of the bridge from any cause, a loss to the company which would have exceeded the entire cost of the

present bridge, it was determined to commence and proceed gradually with the construction of a bridge composed of ontinuous stone arches.

The construction of this bridge commenced in the early part of 1866. The fiscal year of the company until 1872, terminated with the 31st day of August in each year. The expenditures on this bridge up to the 31st day of August, 1866, amounted to $31,269.65, and were charged to the current expenses of repairs of road and bridges.

During the year ending August 31st, 1867, the expenditures on the bridge were $24,442.95, and were charged to the same account.

During the year ending August 31st, 1868, the bridge was completed by an additional expenditure of $23,204.95, which was charged to the same account.

The bridge consists of a series of seven stone arches, each of fifty-four feet clear span, thus affording a water way for the river of 378 feet, while the bridge for which it was substituted gave only a water way of 290 feet.

It has been the practice of the company, for a great number of years, to include in one and the same account all expenditures for repairs of road and tracks and bridges, and at the close of each year to charge to this one account of "repairs of road and bridges," all such expenditures for repairs or renewals of road, tracks and bridges, as seemed proper for keeping the road and structures in a condition to be safe for the use of the public, and economical for the company.

The total expenditure of the company, charged in this account for the year ending August 31st, 1867, amounted to $255,780.32, while for the preceding year ending August 31st, 1866, they were $297,885.93, and for the following year ending August 31st, 1868, they were $326,427.99.

The total income of the road for the year ending August 31st, 1867, was $1,685,334.59. The total expenditure for the same time for repairs of track, bridges and equipments, including renewals of bridges, equipments and structures and all other current and incidental charges for operating the road, except state and national taxes, was $982,518.90, equivalent to 59 per cent. of the gross earnings, and not more than a proper percentage of gross receipts to cover all proper ordinary current expenses and depreciation of the entire property; nor was the percentage of expenses to gross receipts in 1866, any more than a proper one to cover such expenses and such depreciation.

The company paid an United States tax of five per cent. on all dividends paid to its stockholders from its profits during its fiscal year ending August 31st, 1867, and also after closing its accounts and ascertaining its profits for that year, upon the further sum of $123,996.89, being the entire balance of its profits after payment of dividends, which sum was carried to the credit of its contingent fund; and the company paid also on the 10th day of January, 1867, upon the sum of $104,756.61, for like profits and dividends for the year ending August 31st, 1866.

The expenditures on the new bridge in 1866 were at the rate of about $2,000 per month.

The value of the materials in the old bridge when taken down was $1,500, being the price which the company realized.

The cost of putting up a new bridge just like the old one at the time of erecting the stone bridge, would have been $15,000, but the company were assessed upon the entire expense without credit for the value of a bridge equivalent to the old one.

The July dividend in 1866 was duly returned and assessed upon the company by the department and collected of the company on the 7th day of August, A. D. 1866.

The assessment upon which the amount in suit was collected, was made the 13th day of January, 1868, the same being the only reassessment of which the company was appraised, and the form of their notification was upon the ordinary blank, the item of charge being:

Total excise tax, ...	$55,712.60 5
Earnings used in constructing new Windsor bridge, .	2,785.65

From this assessment the company made an appeal to the Internal Revenue Commissioner, according to law, which appeal was disallowed.

The plaintiffs paid to the defendant, under protest, $3,064.21, on the 11th day of February, 1868, under duress, the same being five per cent. upon the amount of the above recited additional assessment and penalty.

The defendant was collector of internal revenue for the first district of Connecticut at the time of his receipt of the money.

The assessment was at the legal rate of five per cent., and the manner of the same was lawful in form.

THE STATUTE.

INTERNAL REVENUE ACT OF JUNE 30TH, 1864, § 122.

Any railroad, canal, turnpike, canal navigation or slack-water company, indebted for any money for which bonds or other evidence of indebtedness have been issued, payable in one or more years after date, upon which interest is stipulated to be paid, or coupons representing the interest, or any such company that may have declared any dividend in scrip or money due or payable to its stockholders, including non-residents, whether citizens or aliens, as part of the earnings, profits, income or gains of such company, and all profits of such company carried to the account of any fund, or used for construction, shall be subject to and pay a tax of five per centum on the amount of all such interest or coupons, dividends or profits, &c.

BRIEF.

There is no error in the judgment below.

I.

It is too patent to require argument that the revenue collector was absurdly tenacious in excluding the most obvious right of the company to appropriate $15,000, the amount necessary to reproduce the old bridge. (fol. 23.)

II.

The expenditures of the company in the years 1866 and 1867 of the sum of $55,712.60, was in no fair sense an application of "profits to construction."

The sum was not of "profits," nor was it used in "construction."

If we go to the political economists for a definition of the term "profits," we shall find one much more liberal to us than our claims.

They even allow a return to capital of a fair amount of interest before coming to profits.

Adam Smith's Wealth of Nations, v. 1, c. 6.
Mill's Pol. Econ., c. 15.

The company had paid a full and generous tax in those years.

Upon their dividends and upon nearly $124,000 for business of 1867, and nearly $105,000 for business of 1866, amounts credited to contingent funds. (fol. 23.)

The profits of a railroad company cannot be claimed to be anything more than the income remaining after satisfying a fair expense account.

It is a fair expense to replace an unsafe bridge with a better one.

If we must account all disbursements as profits, which are in excess of the value of exhausted material and are expended for substitutes, it would make a strange page of expense account.

The purchase of a gold pen would not be accountable as expense if it is a substitute for a quill, nor an investment in a new ticket office with a bay window, in place of a plain one, to better accommodate the public.

We submit that an outlay to repair any breach, which outlay is not intended to work an *enlargement* of the scope of the company's business is properly accounted as a current expense.

It cannot be claimed that the new bridge was designed to meet any enlargement of the company's business.

It held up the same number of tracks and the same identical tracks that its predecessor did. The railroad company, in good neighborliness to the town of Windsor, enlarged the water way, but of course the change in the span of the bridge decreased the length of the company's embankment.

Neither does the fact that the structure is more valuable than the old one, carry the investment out of the page of legitimate current expense.

A railroad station constantly grows in value with the growth of its surroundings, but that growth adds nothing to the company's taxable (to government) or divisible (to stockholders) profits.

Gray v. *Darlington*, 15 *Wallace*, 63.

Nor was the outlay applied to construction. There was no new construction. There was but a bridge across the Farmington river after the job was completed, and there was a bridge across the same river before it was commenced, and the purpose and use of the two structures were identical.

The bridge was lengthened but the embankment was curtailed.

III.

But the conceded facts render the preceding points wholly unnecessary.

It is agreed that the company charged no more for expenses and depreciation of their property in these two years than was "proper to cover such expenses and such depreciation." (fol. 22.)

And these items of extra disbursement are included in those charges.

Of course there can be no such thing as a profit until a proper amount has been charged over for expenses and depreciation.

And the analysis of a single item is neither necessary nor proper unless a concurrent analysis of all other items and also of the omissions of items properly chargeable, is made.

To select an instance of charge here and there for a supposed increase of value in a substitution, and to neglect to set off against that increase the steady and ceaseless depreciation upon the whole $15,000,000 of property of the concern for which no charge has been made, would be neither reasonable nor just.

We submit that any estimate of profits before deducting from income a proper percentage for expenses and depreciation, would be neither fair nor honest, and the form of the charge upon the expense page is immaterial.

The closest analogies to the question now under discussion which we have found, have arisen under the construction of the English poor law.

By the parochial assessments act,

6 *and* 7 *Will.* 4, c. 96,

rates for the relief of the poor in England and Wales are to be made upon an estimate of the *net annual value* of the several hereditaments rated thereunto, that is to say, of the rent at which the same might reasonably be expected to let from year to year, * * deducting therefrom the probable annual average cost of the repairs, insurance and other expenses (if any) necessary to maintain them in a state to command such rent.

Under this act the railway companies are chargeable.

We submit that this law provides for *no deduction which an honest railway management ought not to make before counting its profits.*

And in getting at the net annual value of the several properties, the English courts hold that a "percentage on the gross receipts for annual depreciation of stock beyond ordinary annual repairs," is to be made before coming at the taxable income.

Reg v. *Grand Junction R'y Co.*,
4 *ad. & el. N. S.* 18.

And that another deduction is to be made of "an annual sum per mile for the renewal and reproduction of the rails, sleepers, &c."

Idem.
and Reg v. *G. W. R'y Co.*, 15 *Q. B.* 1085.

And that the company is entitled to deduction of a fair percentage for depreciation, reproduction, &c., *although the amount has not been actually expended.*

Reg v. *Lond., Bright. & So. C. R'y Co.*,
and several other cases following, reported in
15 *Q. B.* 313.

See opinions of the court at page 364.

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